

REPORT OF TARGET EXAMINATION

First Choice Health Plan, Inc.
As of December 31, 1996

DRAFT

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Honorable Deborah Senn
Insurance Commissioner
Office of the Insurance Commissioner
State of Washington
PO Box 40255
Olympia, WA 98504-4025

Pursuant to your instructions and in compliance with the requirements of the state of Washington, a limited scope target examination was conducted of certain corporate affairs and financial records of First Choice Health Plan, Inc., of Seattle, Washington, hereafter referred to as the "Company" or the "Plan" at its home office located at 1100 Olive Way, Suite 1480, Seattle, WA 98101.

SCOPE OF EXAMINATION

The objectives of the target examination were to:

1. Review and assess quality of management.
2. Determine the adequacy of internal controls and assess the reliance that can be placed on the Company's accounts and records.
3. Review Company compliance with state statutes and NAIC regulations pertaining to the compilation and reporting of the annual statement.
4. Determine the overall ability and expertise in health care operations.
5. Review OIC files and documents to determine areas requiring closer review and analysis.

The examination originally targeted the business affairs and financial condition of the Company for the period from organization through December 31, 1996. However, due to the small amount of business produced in 1996, the period was extended to May 15, 1997. The examination was performed in accordance with procedures promulgated by the National Association of Insurance Commissioners (NAIC) for limited scope examinations and in compliance with the provisions of Washington state insurance laws and regulations.

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SUMMARY OF FINDINGS

Based on the information reviewed, the examiner concluded that the Company is competently managed. The Company has experienced significant turnover in the past year, but the current management appears to be knowledgeable and committed to providing health care services in a fair and equitable manner. The Company is new and experiencing growing pains typical to a new company. The financial condition was marginal at year end, but the parent contributed nearly \$5 million in the first quarter of 1997 to assist the Company during this infancy phase. The Company is considering a merger with another HCSC--Health First Partners and an unregulated entity--Health Washington. Health First Partners received a cursory review concurrently with this target examination.

The Company is not a high priority and should be scheduled for a full scope examination in the normal course of examination scheduling.

As a result of the review, the examiner makes the following recommendations:

- 1. The Company should complete the Annual Statement in accordance with the appropriate instructions.*
- 2. Stricter control should be maintained over the check stock and the checks should be written in numerical and succeeding date order to minimize the probability of impropriety and general errors in processing disbursements.*
- 3. Bank reconciliation procedures should be performed in a timely manner every month.*

MANAGEMENT AND CORPORATE RECORDS

First Choice Health Plan, Inc., is a wholly owned subsidiary of First Choice Health Network, Inc., an unregulated provider network. The Network is owned by 11 Hospitals (89%) and 556 Physicians (11%). The hospitals and physicians each have 50% of the voting rights. The Company was incorporated on December 21, 1994, and began operating as a Health Care Service Contractor in January 1995. The Company began writing business in June 1996. All employees work for First Choice Health Network, Inc., under an administrative services contract.

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Board of Directors

Minutes of the Board of Directors meetings were reviewed for the period covered by this examination. No problems or unusual items were noted. The Board did not actually meet, but ratified and approved actions by consent as authorized in the bylaws. The examiners discussed with the Company some of the items that should be documented in the Board Minutes and recommended that the Company keep more detailed information in its minutes, specifically, date and time held and attendees. Additionally, the Board should formally approve items such as bank accounts, check signers, and investments, when made.

Officers

President, Gary Gannaway, (elected 7/1/96). 20 years experience in similar companies.

Nancy Cortez, Vice President, Compliance and Communications. Extensive experience in health care.

Barbara Mauk, Vice President, Director.

Ross Heyl, Vice President and Chief Marketing Officer, has been with First Choice Health Network, Inc., June 1985.

Barbara J. Morrett, Medical Management, RN since 1967, has been with First Choice Health Network, Inc., since May 1993.

David Peel, CFO, Vice President, Product Development and Underwriting, extensive health care background.

Judy Sarafin, Vice President, Operations.

Ricord B. Winstead, M.D., Vice President, Medical Director.

Although the Company is new, the management does have extensive experience in the health care service industry.

Reinsurance

The Company does not have excess of loss reinsurance. It does require its capitated providers to carry it, and to name the Company as an insured, for which the Company pays a portion of the premium.

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Annual statement review

Due to the short amount of time the Company has been writing business, the December 31, 1996 statement was reviewed. The following errors were noted:

1. The Secretary did not sign the annual statement.
2. The Company incorrectly completed question 20 on General Interrogatories. This comment relates to the state insurance department examination. The answer to this question should be no.
3. The Notes to Financial Statements was left totally blank.
4. The Company had two investments that exceeded the 4% limitation at December 31, 1996. As of March 31, 1997, the problem was corrected with the addition of \$5,000,000 of paid in capital.
5. On Page 27, line 7, decrease by adjustment in book value for Schedule D - verification between years, does not agree with page 32, column 11 on Schedule D - Part 1 which is blank.
6. Principal payments received on Schedule D, Part 4 were listed as a lump sum and were not identified to individual bonds.
7. Schedule Y, Part 1 is blank. It should have an organizational chart of the corporate group.
8. Schedule T, Column 3 is blank and should have the premium dollars by state.
9. No middle names were used for Officers and Directors on the Jurat Page, as per Annual Statement instructions.

Intercompany Agreements

The Company shares services with its parent, First Choice Health Network, Inc. An intercompany agreement formalizing this arrangement is dated January 12, 1995.

ACCOUNTING RECORDS AND PROCEDURES

Fluctuation Analysis

Due to the short financial history of the Company, no definite conclusions could be derived from the fluctuation analysis. The Company's financial statements showed marked fluctuations; however, these variances were attributed to the Company's startup operations.

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Receipt Analysis

As of December 31, 1996, the Medicare Select product, administered by the TPA, was the sole line of business produced by FCHP. Olympic Management Health Systems, the TPA, performs billing and collection procedures for the Medicare Select business. The TPA provides monthly reports detailing sales, current enrollment and other information pertinent to the Medicare product.

Medicare premium receipts are deposited into a Seafirst zero balance account in the name of the Company. Deposits are then transferred to a concentration account. Funds are transferred to the zero balance disbursement account as needed.

As of January 1, 1997, the Company began writing commercial business. There are approximately 18 groups subscribing-as of this report. The parent company, First Choice Health Network, Inc., (FCHN) acts as the TPA for the commercial business. FCHN generates billing statements approximately 25 days prior to the period when coverage becomes effective. Subscribers pay by check which is deposited into a lockbox at Seafirst Bank. Premium payments are entered into the Great Plains Software system based on a validated deposit slip received from Seafirst. Items are then posted against accounts receivable.

Bank Reconciliation

Bank reconciliation procedures are currently performed by the Great Plains system which receives information from the Diamonds software system, permitting reconciliation of all bank accounts. Reconciliations are performed monthly. Prior to March 28, 1997, there were problems importing data from the Diamonds to the Great Plains systems. As of this writing, these problems have been resolved and cash management procedures are in place.

Sample of Receipts

Bank statements, reconciliations, and premium receipts supporting documentation were obtained and reviewed on a sample basis for 1996 and 1997. Prior to January 1, 1997, the Medicare product was the only line of business offered. The TPA reconciles the Seafirst accounts related to the Medicare product and those reconciliations were not available for this target examination. Because of the small amount of premium collected for Medicare business, no further review was made. In January 1997, the Company added a commercial product which generates the majority of premium income each month. Premium receipts for the Medicare and commercial lines of business are deposited into separate Seafirst bank accounts in the name of First Choice Health Plan, Inc. Transactions were tested on a sample basis and appear reasonable.

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The controls in place for receipts appear to be adequate. No recommendations are deemed necessary.

Disbursement analysis

The disbursement cycle includes claims and administrative payments. The administrative disbursement cycle includes all disbursements other than those for claims. The parent company, First Choice Health Network, Inc., pays all operational accounts payable for the subsidiary company.

Controls in place for administrative disbursements include:

1. Invoices are date stamped and coded.
2. Expenses are entered onto the system by accounting code.
3. Invoices are forwarded to the appropriate vice president for approval. Once the invoice is approved, checks are run once each week.
4. The CEO, CFO and VP of Operations are authorized to sign checks. Checks over \$5,000 require two signatures.

At quarter end, a summary of the Company's portion of expense is produced and First Choice Health Plan, Inc., reimburses the parent company.

The majority of disbursement activity for the first quarter of 1997 occurs with the claims and capitated payments account held at Seafirst Bank. Disbursements made by the Medicare TPA were not reviewed in detail.

There is inconsistency in the numerical order of checks written from what is recorded in the check registers provided during the review. The explanation provided was that Management wanted to run capitated primary care physical checks so the first 50 checks in the stock were removed so that the capitated payments could be made.

It was noted that the reconciliation of disbursement bank accounts was not always performed in a timely manner. For example, reconciliation of the February and March 1997 disbursement/claims bank account was performed on May 9, 1997. The accounting manager explained that reconciliation procedures were delayed because the Company had problems importing information from the Diamonds system into the Great Plains system which performs the reconciliation of bank accounts. The problems were solved prior to the examination.

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Disbursement Sample

Fifteen claims disbursements were reviewed to determine if the internal controls for disbursements were being followed. Documentation provided for each claim were: Health Insurance Claim Form, screen prints from the Diamond system, the Explanation of Benefits (EOB), and the remittance advice. Actual canceled checks were provided to verify payments were made. The checks were tied to the check register verifying check number, check date, check amount, vendor id and vendor name, without exception.

Some internal control weaknesses exist. Reconciliations should be approved by a supervisor to minimize errors and misrecorded items. It is also recommended that management review the Medicare TPA's policies regarding disbursements to assure adequate controls are in place.

Investment analysis

The Company holds investments in Nordstrom Credit, General Motors Acceptance Corporation, and Federal Home Loan Collateralized Mortgage Obligations in addition to overnight funds. At December 31, 1996, the investment in both Nordstrom and General Motors exceeded the 4% asset limitation. As of March 31, 1997, the parent contributed an additional \$4.9 million in capital and the investments no longer exceed the limitation.

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Securities on Deposit

RCW 48.44.030 requires a Health Care Service Contractor to place securities on deposit with the State of Washington in an amount equal to the greater of \$150,000 or the amount necessary to cover incurred but unpaid reimbursements. The Company's balance of incurred but unpaid reimbursements as of December 31, 1996 was \$19,049. The balance on deposit with the State of Washington as of December 31, 1996 was \$150,579.24, which fulfills the legal requirements.

Claims Reserves

Medicare Supplement plans were the sole line of business produced by the Company in 1996 and there is insufficient history on the claim reserves to do an analysis. The Company did not use an actuary to develop the reserves at year end, but used the information provided by the TPA to calculate the reserves. The Company plans to hire an actuary to develop the reserves now that the commercial policies are being sold.

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ACKNOWLEDGMENT

Acknowledgment is hereby made of the cooperation extended to the examiners by the officers and employees of the Company during the course of this examination.

Laura A. Young, AFE, Examiner-in-Charge, Lisa Kelly, AFE, from the Washington Insurance Commissioner's Office participated in the examination and the preparation of this report.

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AFFIDAVIT

STATE OF WASHINGTON)
) ss
COUNTY OF KING)

Laura A. Young, being duly sworn, deposes and says that the foregoing report subscribed by her is true to the best of her knowledge and belief.

Laura A. Young, AFE
Examiner-in-Charge
State of Washington

Subscribed and sworn to before me this _____ day of _____, 1997

Notary Public in and for the
State of Washington, residing
at Seattle.